

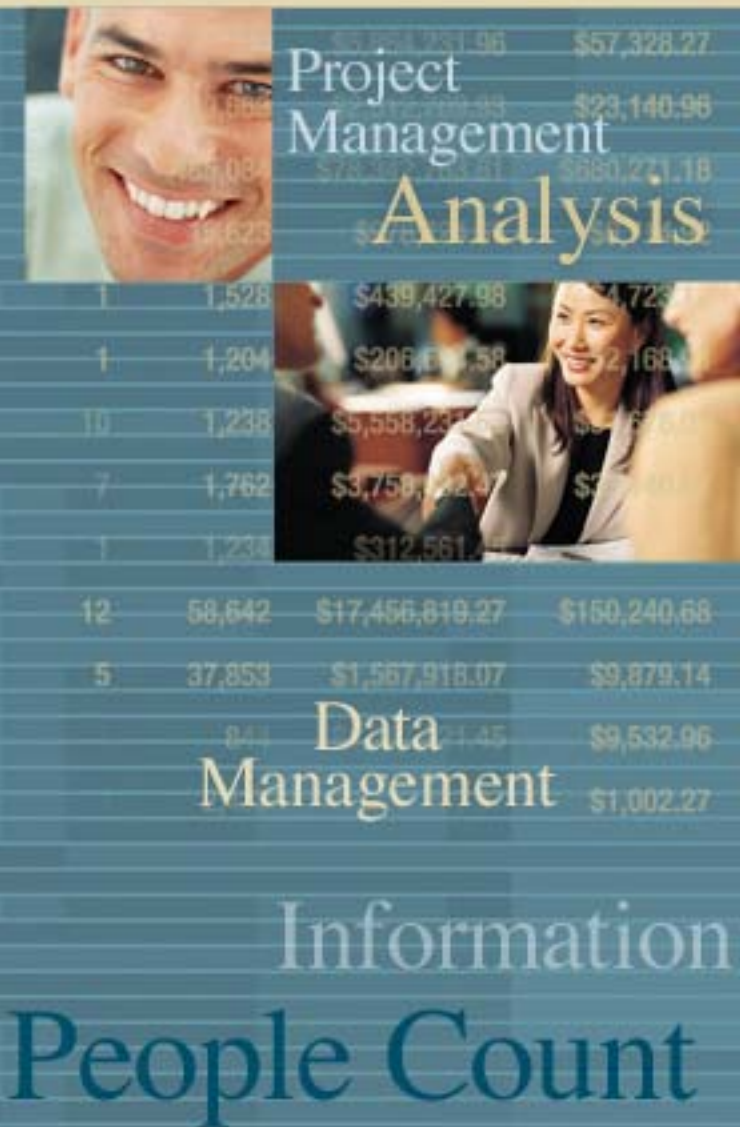
# *Understanding Arbitrage*

California Debt and Investment Advisory  
Commission

March 17<sup>th</sup> 2006

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Rauth



# *What is Arbitrage Rebate?*



Project  
Management  
Analysis



Data  
Management

Information  
People Count

Project  
Management

## Analysis

\$5,884,231.96 \$57,328.27

\$2,512,769.93 \$23,140.96

\$78,342,763.81 \$680,271.18

\$978,724.67 \$8,714.92

\$439,427.98 \$4,723.12

\$206,654.58 \$2,168.93

\$5,558,231.53 \$51,678.03

\$3,758,032.47 \$31,140.92

\$312,561.45 \$2,567.10

\$17,456,819.27 \$150,240.68

\$1,567,918.07 \$9,879.14

Data  
Management \$9,532.96  
\$1,002.27

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## *What Is Arbitrage Rebate?*

- ✓ Unless an exception is available, the IRS requires a payment to the US Treasury equal to all interest earned on bond proceeds in excess of the bond yield
- ✓ Payments are due every five years and on final redemption date or maturity of the bond issue

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## *Consequences of Noncompliance*

- ✓ Stiff penalties are imposed if arbitrage payments are late or yield restrictions are violated
- ✓ Non-payment of arbitrage rebate may affect the tax-exempt status of the bonds
- ✓ IRS reserves the right to audit any tax-exempt bond for arbitrage rebate compliance even after the bonds have been fully redeemed



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# *Advantages to Implementing An Effective Arbitrage Reporting Program*

- ✓ Paying rebate means investment earnings are maximized which provides additional funds to complete projects or to pay debt service
- ✓ Being prepared for refinancings and IRS audits which can occur at any point during the life of the bond or beyond
- ✓ Being in compliance with bond document covenants

# *Managing Arbitrage Rebate Compliance*



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## *Managing Your Rebate Program*

- ✓ Establish good policies and procedures for managing your bond issues
- ✓ Negotiate the provisions of the Tax Certificate
- ✓ Stay organized
- ✓ Maintain a rebate reporting schedule that allows time for decisions at critical junctures

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## *Policies and Procedures*

- ✓ Analyze activity on your bonds for all purposes, not just rebate
- ✓ Maintain consistent procedures
- ✓ Consult with Bond Counsel before making critical decisions relating to your tax-exempt debt, such as redeeming bonds early or changes in the use of proceeds or bond financed facilities



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## *Negotiate the Provisions of your Tax Certificate*

- ✓ Do not allow the drafter to routinely include boiler plate language in your Tax Certificate - make sure you understand the representations you are making and covenants you are undertaking
- ✓ Be sure you agree with any and all special elections
- ✓ Read the Tax Certificate

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## *Stay Organized*

- ✓ Track bond proceed investment and expenditures in detail
- ✓ Avoid commingling funds whenever possible
- ✓ Retain all records for the life of the bond, plus 3 years

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## *Recommended Reporting Schedule*

- ✓ Annual reporting on all variable rate issues and fixed rate bonds that have accrued liabilities
- ✓ Initial calculation at the end of the first bond year to monitor special elections and optimize investment strategies
- ✓ Review after year 3 when the construction fund must be yield restricted
- ✓ Minimum reporting schedule - every 5 years

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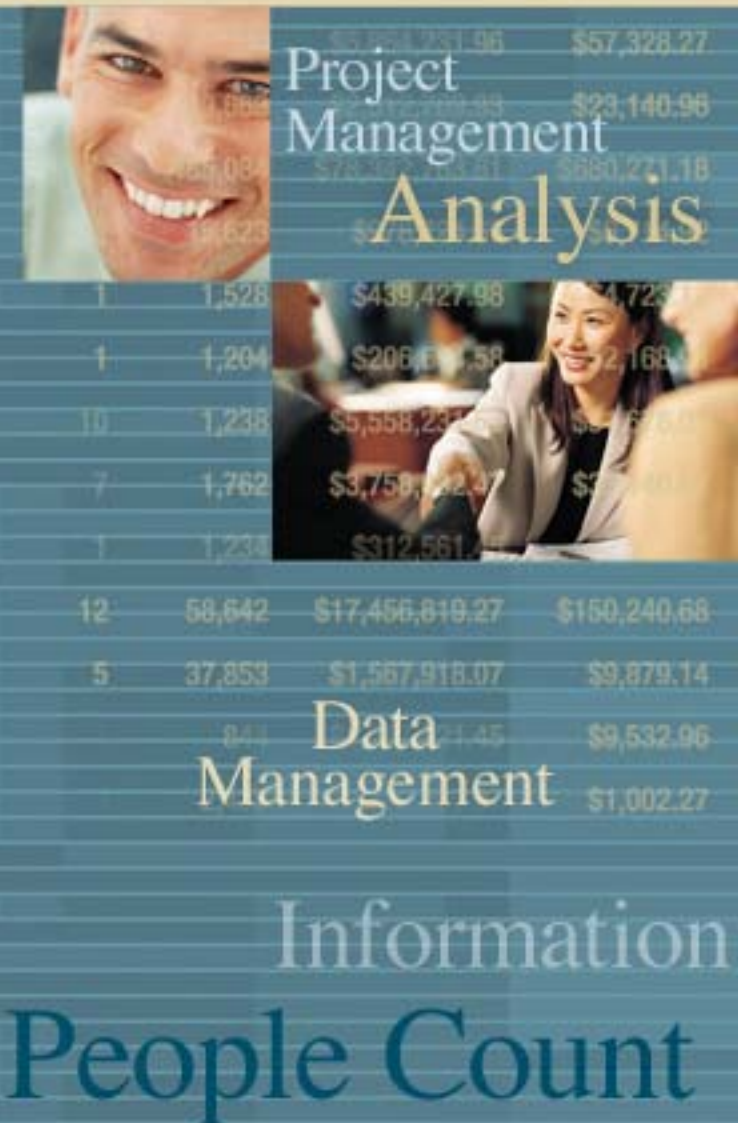
# Sample Tracking System

## Agency Arbitrage Rebate Compliance Summary as of 1/31/04

Issue Date	Original Principal	Issue Name	Last Report	Liability	Next Report
10/07/1993	\$2,405,000.00	Peacock Gap Refunding	10/01/1998	(\$26,061.00)	10/01/2003
01/28/1997	\$5,250,000.00	1997 Revenue Bonds	05/31/2003	(\$42,382.16)	01/28/2007
06/30/1999	\$23,504,004.00	1999 TAB	06/30/2003	\$215,345.89	06/30/2004
12/06/2001	\$3,220,000.00	2001 Revenue, Series A	-	-	12/06/2006
10/20/2002	\$25,020,000.00	TARB Series 2002	-	-	10/20/2007
04/17/2003	\$7,605,000.00	2003 Lease Revenue Bonds	-	-	04/17/2008



# *Arbitrage Rebate Defined*



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4	694	\$1,112,864.34	\$10,273.45
1	1,528	\$439,427.98	\$4,723.98
1	1,204	\$208,617.58	\$2,168.98
10	1,238	\$5,558,231.45	\$5,619.98
7	1,762	\$3,759,142.37	\$7,200.98
1	1,234	\$312,561.45	\$1,002.27
12	58,642	\$17,456,819.27	\$160,240.68
5	37,853	\$1,567,918.07	\$9,879.14
843	21.45	\$9,532.96	

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# *Definition of Arbitrage*

- ✓ Basic definition of Arbitrage
  - Profit from buying something in one market and selling it in another
- ✓ As related to the municipal bond market
  - Municipality's profit from borrowing funds in the tax-exempt market and investing them in the taxable market
- ✓ Interest rates of tax-exempt municipal bonds are lower than taxable due to the tax preference

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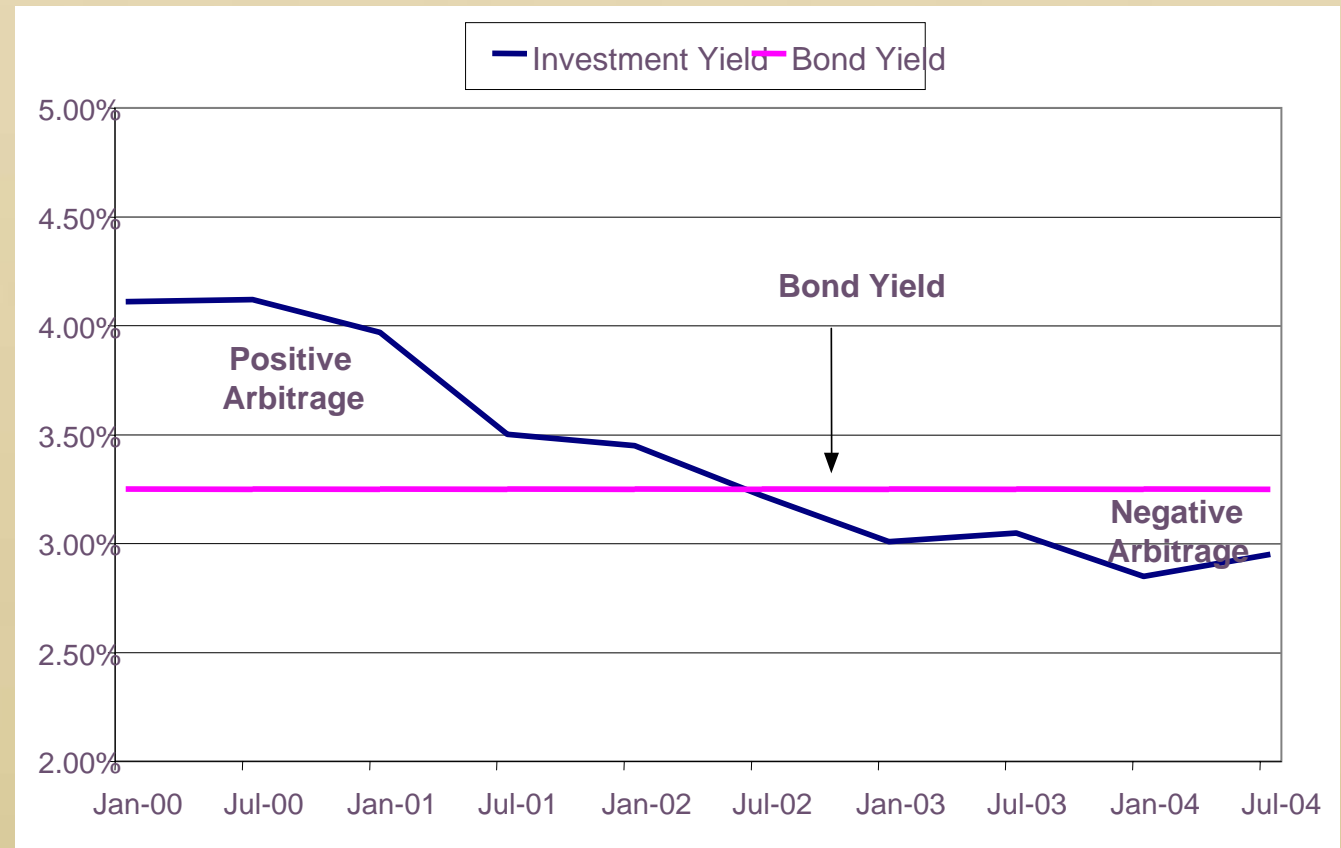
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# Graphic Illustration of Arbitrage



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# *Defining Bond Yield*

- ✓ Bond yield
  - Discount rate used to present value all payments of principal and interest on a bond issue that produces an amount equal to the purchase price
- ✓ Purchase Price of Bond Issue
  - Par amount adjusted for accrued interest, original issue discounts and/or premiums, and credit enhancement
- ✓ Conventions – 360 day year (30 day months) with semi-annual compounding
- ✓ Fixed vs. Variable rate issues



# *Overview of the Regulations*



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# *Regulations Governing Bonds Issued Prior to June 30, 1993*

## ✓ 1992 Regulations

- Bonds issued between September 1, 1986 and June 30, 1993
- Computation credit - \$3,000 at installment and at maturity (at least one year since last computation credit)
- If early bond year not elected, bond year ends the day before the issue date

## ✓ Can elect into the 1993 Regulations

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# *Overview of Current Regulations*

## ✓ 1993 Regulations

- Bonds issued after June 30, 1993
- Computation credit - \$1,000 annually and at maturity
- If early bond year not elected, bond year ends on the issue date

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Management

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# *Payment Requirements*

## ✓ Installment Dates

- Every 5 years from issue date or bond year
- Bond year election – first year can be shorter than a year
- 90% payments due within 60 days

## ✓ Final Maturity

- Date bonds matured or redeemed early
- 100% payment due within 60 days



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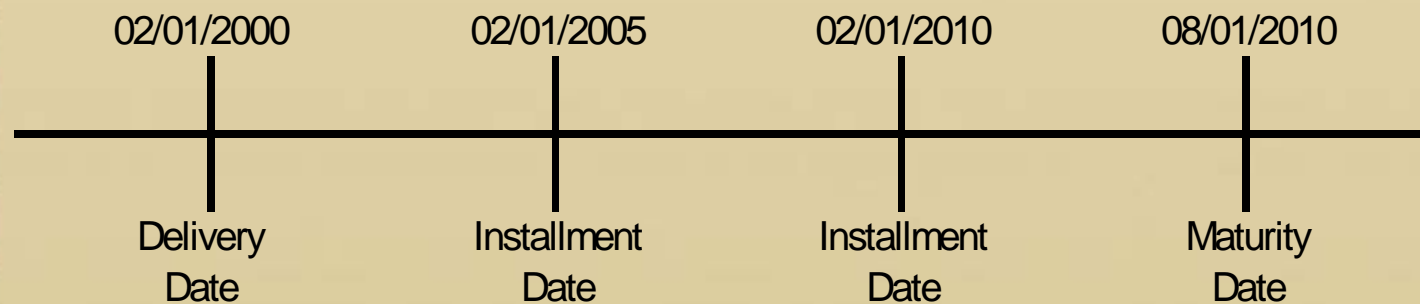
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## *Illustration of IRS Payment Dates*

- ✓ Bonds issued February 1, 2000
- ✓ Bond year not elected
- ✓ Issue date used for anniversary dates
- ✓ Maturity is less than 5 years from last installment date



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## *IRS Form 8038-T*

- ✓ Form 8038-T only filed when there is a positive liability and/or yield reduction payment needed
- ✓ Check payable to US Treasury
- ✓ Mail rebate or yield reduction payment to IRS Center in Ogden, UT

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# *Two Sets of Rules*

## ✓ Arbitrage Rebate

- Requires arbitrage profits to be “rebated” to the federal government
- Exceptions to Rebate

## ✓ Yield Restriction

- Proceeds are prohibited to be invested above the bond yield
- Exceptions to Yield Restriction

# *Yield Restriction*



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## *Yield Restriction*

- ✓ In general, gross proceeds may not be invested at a yield materially higher than the yield on the bonds
- ✓ Materially higher
  - 1/8 of one percent (.125%)
  - 1/1000 of one percent (.0001%) for advance refunding Escrows

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## *Exceptions to Yield Restriction*

- ✓ Temporary Periods
- ✓ Reasonable Required Reserve Fund
- ✓ Minor Portion
  - Lesser of \$100,000 or 5 percent of proceeds

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# *Temporary Periods*

## ✓ Three Year Temporary Period

- Within six months from issue date, issuer incur a substantial binding obligation to a third party to expend 5% of net sale proceeds
- 85% of net sale proceeds expended on capital project(s) within three year period
- Issuer proceeds with "due diligence" to complete capital projects

## ✓ Project Funds, Capitalized Interest and Costs of Issuance qualify for three year temporary period

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# *Other Temporary Periods*

- ✓ Five Year Temporary Period
  - Substantial amount of construction expenditures on a complex construction project
  - Issuer and licensed architect or engineer certifies that five year period is necessary to complete capital project
- ✓ Investment Proceeds have one year from date of receipt
- ✓ Working Capital Expenditures/Operating Expenses have thirteen months
- ✓ Pooled Financings
  - Six Month Period to loan out proceeds
  - Repayments from loans have only three months



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## *After the Temporary Period*

- ✓ Yield restrict remaining proceeds, or
- ✓ Yield reduction payment may be permitted under 1993 Regulations

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## *Yield Reduction Payments*

- ✓ 1993 administrative solution to yield restriction
- ✓ Yield Reduction Payments (YRPs) are payments made to the IRS on yield restricted funds
- ✓ Paid at same time and manner as a rebate payment

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## *Yield Reduction Payments*

- ✓ YRPs allowed for the following situations:
  - Investments qualified for an original temporary period
  - Investments restricted to a variable yield issue
  - Transferred proceeds associated with a refunding
  - Reserve fund balance in excess of reasonably required limit, but only up to 15% par
- ✓ YRPs not allowed for advance re-funding escrows

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\$3,758,032.47 \$31,140.92

\$312,561.45 \$2,567.10

\$17,456,819.27 \$150,240.68

\$1,567,918.07 \$9,879.14

Data  
Management

\$9,532.96

\$1,002.27

Information

People Count

## *Illustration of Yield Reduction Payment*

- ✓ Payments after temporary period is a yield reduction payment
- ✓ Cannot blend negative rebate liability with positive yield reduction liability
- ✓ Can blend positive rebate liability with negative yield reduction liability

		Arbitrage Earned		
	Period	Example No. 1	Example No. 2	Example No. 3
Years 1-3	Unrestricted	\$10,000	(\$9,000)	\$8,000
Years 4-5	Restricted	\$5,000	\$7,000	(\$2,000)

Rebate Payment	\$10,000	\$0	\$6,000
Yield Reduction Payment	\$5,000	\$7,000	\$0



# *Arbitrage Rebate*



Project  
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Analysis



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Project  
Management

## Analysis

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Data  
Management \$9,532.96  
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## *Arbitrage Rebate*

- ✓ Should you qualify for exception to yield restriction and generate positive arbitrage, you must rebate this amount to the federal government unless an exception is available
- ✓ Exceptions to Rebate allows issue in certain cases to keep positive arbitrage

Project  
Management

## Analysis

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## *Exceptions to Rebate*

- ✓ Small Issuer Exception
- ✓ Spending Exceptions
- ✓ Bona Fide Debt Service Funds

Project  
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## Analysis

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# *Small Issuer Exception*

## ✓ Requirements

- Issuer must have general taxing powers
- Not “Private Activity” Bonds
- 95% or more proceeds used toward local government activities
- Aggregate tax-exempt debt must not exceed \$5 million within a calendar year



Project  
Management

## Analysis

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## *Small Issuer Exception for Schools*

- ✓ Relates to bonds to finance construction of public school facilities
- ✓ January 1, 1998 limit increased to \$10 million
- ✓ January 1, 2002 limit increased to \$15 million
  - \$10 million must be used for construction of public school facilities
  - \$5 million for non-construction purposes (e.g. TRANS)

Project  
Management

## Analysis

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## *Illustration of Small Issuer Exception for Schools*

- ✓ Case 1 and Case 2 are acceptable
- ✓ Case 3 does not qualify for the exception to rebate

	Case 1	Case 2	Case 3
	Exempt	Exempt	Non Exempt
Construction	\$10,000,000	\$12,500,000	\$9,000,000
Non-Construction	5,000,000	2,500,000	6,000,000
Total Issue Amount	<b>\$15,000,000</b>	<b>\$15,000,000</b>	<b>\$15,000,000</b>

Project  
Management

## Analysis

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# *Spending Exceptions*

- ✓ Six Month Spending Exception
- ✓ Eighteen Month Spending Exception
- ✓ Twenty-Four Month Spending Exception

Project  
Management

## Analysis

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## *Six Month Spending Exception*

- ✓ Applies to any type of tax-exempt issue
- ✓ 6 months - 100% proceeds spent
- ✓ 501(c)(3) and governmental bonds have additional 6 months to spend 5% of proceeds
- ✓ Private activity bonds are not afforded the additional 6 months

Project  
Management

## Analysis

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People Count

# *Eighteen Month Spending Exception*

## ✓ Requirements

- Applies to any type of tax-exempt issuance for a capital project including industrial bonds or qualified mortgage bonds

## ✓ Schedule

- 6 months – 15%
- 12 months – 60%
- 18 months – 100%



Project  
Management

## Analysis

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Management \$9,532.96  
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# *Twenty-Four Month Spending Exception*

## ✓ Requirements

- Applies to governmental bonds, 501(c)(3), or private activity bonds used for construction purposes
- Issuer reasonable expects that 75% of available construction proceeds will be used for construction expenditures
- Construction expenditures must be on property that is to be owned by a governmental unit or 501( c)(3) organization

Project  
Management

## Analysis

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Data  
Management \$9,532.96  
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People Count

# *Twenty-Four Month Spending Exception*

## ✓ Schedule

- 6 months – 10%
- 12 months – 45%
- 18 months – 75%
- 24 months – 100%

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Management

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## *De Minimis Exception and Reasonable Retainage*

- ✓ 18 month and 24 month exceptions
- ✓ De Minimis Exception
  - Lesser of 3% of issue price or \$250,000
  - Exercise due diligence to complete project
- ✓ Reasonable Retainage
  - Additional 12 months to spend 5% of proceeds
  - Amount retained for business purposes relating to the financed property

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Management

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## *Bona Fide Debt Service Funds*

- ✓ Funds used primarily to achieve a proper matching of revenue and debt service within each bond year
- ✓ Funds must deplete annually to zero with exception of reasonable carryover amount

Project  
Management

## Analysis

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## *Reasonable Carryover Amount*

- ✓ Earnings from the prior bond year
  - Deposited exact amount of debt service needed and earnings left behind
- ✓ One-twelfth of prior year's debt service
  - Revenues deposited monthly and is a month ahead of debt service payment date



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Management

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## *Bona Fide Debt Service Fund Earnings Limitation*

- ✓ DSF is exempt from rebate if gross earning is less than \$100,000 within a bond year
- ✓ Fixed rate issues with an average maturity of 5 years or more - DSF is excluded from rebate regardless of amount of interest earned
- ✓ Fixed rate issues with an average maturity of less than 5 years and variable rate issues - include in rebate calculation if more than \$100,000 earned in bond year

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Management

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Management \$9,532.96  
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## *Debt Service Fund Safe Harbor*

- ✓ Issue with an average annual debt service of \$2,500,000 or less may be treated as satisfying the \$100,000 limitation

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Management

## Analysis

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People Count

## *Reasonable Required Reserve Fund*

- ✓ Should not exceed the lesser of
  - 10% of principal amount
  - Maximum annual debt service
  - 125% of the average annual debt service
- ✓ Excess Reserve Portion
  - Must be funded from other source (revenues), not sale proceeds
  - Excess amount must be yield restricted

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Management

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## *Penalties for Noncompliance of Arbitrage Regulations*

- ✓ Bonds declared "Taxable" (loss of tax-exemption)
- ✓ If failure to pay was not due to willful neglect, assessment of penalties and interest

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Management

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# *Penalty Assessment Rates*

- ✓ Penalty equal to:
  - 50% for governmental bonds, or
  - 100% for private activity bonds, excluding qualified 501(c)(3) bonds
- ✓ Interest also payable on correction amount, calculated on underpayment quarterly rates



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# *Recovery of Overpayments*

## ✓ 1992 Regulations

- Only permitted for mathematical errors

## ✓ 1993 Regulations

- Permitted whenever an overpayment can be demonstrated

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## *Limitations on Recovery*

- ✓ Use Form 8038R for filing
- ✓ An overpayment of less than \$5,000 may not be recovered before the final computation date
- ✓ Overpayment can only be recovered to the extent that recovery does not result in additional rebate as of the date requested

# *Tax and Revenue Anticipation Notes*



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## *TRANS*

- ✓ TRANS are issued to cover working capital needs while waiting to receive revenues from other sources
- ✓ Proceeds may be invested above the bond yield, but earnings will be subject to rebate unless the issue qualifies for a spending exception or small issuer exception

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Management

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## *Special Rules for TRANs*

- ✓ Temporary period will be 13 months
- ✓ Issuer must use “proceeds-spent-last” accounting method for working capital



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## *Small Issuer Exception*

- ✓ The "Small Issuer Exception" applies in the same manner to TRANs as to other capital project tax-exempt debt in that it exempts an Issuer from rebate
- ✓ TRAN issuers are not exempt from Yield Restriction and therefore must establish a 13 month temporary period

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# *“Proceeds-Spent-Last” (PSL)*

- ✓ An issuer is not allowed to treat bond proceeds as spent until all other available working capital has been spent
- ✓ PSL is mandatory for working capital expenditures. Even if bond proceeds are segregated you cannot allocate expenditures until all other available sources have been used

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# *Available vs Unavailable Working Capital*

- ✓ Available Amount is any amount that may be used by the issuer for working capital expenses
- ✓ Unavailable Amount is any amount held by the issuer which has been restricted by legislative, judicial, or contractual action as to the use of proceeds

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## *Working Capital Reserves*

- ✓ The regulations allow an issuer to set aside a “working capital reserve” and thus treat it as an unavailable amount
- ✓ For small issuers, this amount may not exceed 5% of the working capital expenses of the prior fiscal year; special rules apply for large issuers

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# *De Minimus Exceptions From PSL*

- ✓ Numerous De Minimus exceptions exist with relation to PSL
- ✓ The most commonly used exceptions are for costs defined as administrative cost of issuing the bonds, qualified guarantee fees, payment of rebate, and yield reduction payments



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Management \$9,532.96  
\$1,002.27

Information

People Count

# *De Minimis Exceptions From PSL*

- ✓ PSL does not apply to extraordinary, nonrecurring items, such as casualty losses
- ✓ Does not apply to principal and interest on prior issues
- ✓ Does not apply to interest unless it is allocable to construction or prior to the production of revenues
- ✓ Your bond counsel or rebate provider can provide a complete list

Project  
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## Analysis

\$5,884,231.96 \$57,328.27

\$2,512,769.93 \$23,140.96

\$78,342,763.81 \$680,271.18

\$978,724.67 \$8,714.92

\$439,427.98 \$4,723.12

\$206,654.58 \$2,168.93

\$5,558,231.53 \$51,678.03

\$3,758,032.47 \$31,140.92

\$312,561.45 \$2,567.10

\$17,456,819.27 \$150,240.68

\$1,567,018.07 \$9,879.14

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## *Cumulative Cash Flow Deficit (CCFD)*

- ✓ Regulations do not restrict investment of TRAN proceeds provided the face amount of the TRAN does not exceed the cumulative cash flow deficit
- ✓ For small issuers, CCFD calculated for a fiscal year is:
  - Beginning Balance
  - + Anticipated Receipts
  - Anticipated Expenses
  - Cumulative Cash Flow Deficit
- ✓ Actual facts are used for large issuers

Project  
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## *Safe Harbor for TRANs*

- ✓ If the CCFD six months after the issue date is at least 90% of the TRAN proceeds, the issue will qualify for the 6-month spending exception

# *Enforcement*



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## *Definition of Abusive*

- ✓ Abusive arbitrage is defined as:
  - An action that enables the issuer to *exploit* the difference between tax-exempt and taxable interest rates, and
  - *Overburdening* the tax-exempt market



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## *Overburdening*

- ✓ Issuing bonds too early or allowing them to stay outstanding longer than necessary is considered overburdening the market

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## *Recent Abuses in the News*

- ✓ Yield Burning
- ✓ Improper yield blending
- ✓ Hidden fees in credit enhancements
- ✓ Bonds issued for the purpose of earning arbitrage

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## *How to Protect Yourself*

- ✓ Ask questions, if it sounds too good to be true, it may be
- ✓ Consult an objective party, such as bond counsel, who can clarify the impact of the transaction as it relates to the IRS regulations
- ✓ Learn the basics of arbitrage